BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
P. LORILLARD COMPANY)

Appearances:

For Appellant: Robert H. Walker, its Attorney.

For Respondent: J. J. Arditto, Franchise Tax Counsel.

O P I N I O N

This appeal is made pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner upon the protests of P. Lorillard Company to his proposed assessments of additional taxes in the amounts of $3,143.66, $2,954.79 and $4,242.78 for the taxable years ended December 31 of 1937, 1938 and 1939, respectively. Upon the consideration of the protests the Commissioner redetermined the additional taxes to be $3,037.61, $2,704.41 and $3,967.54, respectively.

Appellant was incorporated under the laws of the State of Delaware. Its parent company, P. Lorillard Company of New Jersey, was incorporated under the laws of the State of New Jersey and owned more than 50% of Appellant's outstanding stock. The parent owned all but 475 shares of the outstanding 6,000 shares of stock of another of its subsidiaries, Federal Tin Company, which was incorporated under the laws of New York. Those 475 shares were owned by employees of Federal Tin Company. The parent company and the Federal Tin Company did not do business in California. During the years in question the Appellant was engaged in the sale of tobacco products purchased from its parent company and was doing business in California as well as in other states. Appellant alleges that all merchandise sold by the parent company to-it was sold at the same prices as were available to other purchasers, less additional discounts, and that it made a fair profit on the resale of such merchandise. Each of the three corporations was at all times independently and separately managed and operations of each were separately accounted for. Appellant, in filing its franchise tax returns, based them on a separate accounting system while the Commissioner determined its tax liability by applying a three-factor allocation formula to the combined net income of the three corporations.

The action of the Franchise Tax Commissioner in allocating to California a portion of the combined net income of the three corporations is based on Section 14 of the Act. That section, as amended in 1935 and applicable to the Appellant's taxable year ended

December 31, 19.37, provided as follows:

> "Sec. 14. In the case of two or more corporations or banks or of one or more banks and one or more corporations owned or controlled directly or indirectly by the same interests, the commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such corporations or banks, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such corporations or banks.
>
> "In the case of a corporation doing business within the meaning of this act, whether under agreement or otherwise, in such manner as either directly or indirectly to benefit the members or stockholders of the corporation, or any of them, or any person or persons, directly or indirectly interested in such business, by rendering services of any nature whatsoever or acquiring or disposing of its products or the goods or commodities in which it deals, at less than a fair price therefor; or where such a corporation owned and/or controlled either directly or indirectly by another corporation or corporations, renders services of any nature whatsoever, or acquires or disposes of the products of the corporations so owning and/or controlling such corporation, in such a manner as to create a loss or improper net income, the commissioner, in order to prevent evasion of taxes or clearly to reflect the income of such a corporation, may require a report consolidated with the owning and/or controlling corporation or corporations, or such other facts as he deems necessary, and may determine the amount which shall be deemed to be the entire net income allocable to this State of the business of such corporation for the calendar or fiscal year, and compute the tax on such net income. In determining the entire net income the commissioner shall have regard to the fair profits which but for any agreement, arrangement, or understanding? might be or could have been obtained from dealing in such products, goods or commodities." (Statutes 1935, p. 998)

The Section, as amended in 1937 and applicable to the Appellant's taxable years ended December 31, 1938, and 1939, provided as follows:

> "Sec. 14. In the case of two or more corporations or banks or of one or more banks and one or more corporations owned or controlled directly or indirectly by the same interests, the commissioner may permit or require the filing of a combined report

"and such other information as he deems necessary and is authorized to impose the tax due under this act as though the combined entire net income was that of one corporation, or to distribute, apportion, Or allocate the gross income or deductions between or among such corporations or banks, if he determines that such consolidation, distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such corporations or banks.

"In the case of a corporation doing business within the meaning of this act, whether under agreement or otherwise, in such manner as either directly or indirectly to benefit the members or stockholders of the corporation, or any of them, or any person or persons, directly or indirectly interested in such business, by rendering services of any nature whatsoever, or acquiring or disposing of its products or the goods or commodities in which it deals, at less than a fair price therefor, the commissioner, in order to prevent evasion of taxes or clearly to reflect the income of such corporation, may require a report of such facts as he deems necessary, and may determine the amount which shall be deemed to be the entire-net income allocable to this State of the business of such corporation for the calendar or'fiscal year, and compute the tax upon such net income. In determining the entire net income the commissioner shall have regard to the fair profits which, but for any agreement, arrangement, or understanding, might be or could have been obtained from dealing in such products, goods or commodities.

"In the case of a corporation liable to report under this act owning or controlling, either directly or indirectly, another corporation, or other corporations, and in the case of a corporation liable to report under this act and owned or controlled, either directly or indirectly, by another corporation, the commissioner may require a consolidated report showing the combined net income or such other facts as he deems necessary. In case it shall appear to the commissioner that any arrangement exists in such a

> manner as to improperly reflect the business done or the net income earned from the business done in this State, the commissioner is authorized and empowered, in such manner as he may determine, to assess the tax against either of the corporations whose net income is involved in the report upon the basis of the combined entire net income and such other information as he may possess, or he may adjust the tax in such other manner as he shall determine to be equitable." (Statutes 1937, p. 2337)

In the memoranda filed in support of their resepctive positions, the parties have regarded Section 14 as amended in 1937 as applicable to the three taxable years involved herein and the Section as then amended will, accordingly, be first considered.

The Appellant takes the position that the action of the Commissioner in combining the income of a corporation doing business in California with that of its parent and another subsidiary, neither of which is doing business in the State, can be justified only by the third paragraph of Section 14. It then contends that the Commissioner acted improperly in this case in combining its income with that of P. Lorillard Company of New Jersey and the Federal Tin Company, neither of which did business in California during the years in question, since there had been no showing by the Commissione that "any arrangement" existed "in such a manner as to improperly reflect the business done or the net income earned from the business done in this State" as required by the Section. The Appellant alleges, and its allegation is not controverted by the Commissioner, that the prices at which P. Lorillard Company of New Jersey sold tobacco products to Appellant were fair and that no arrangement existed between any of the three corporations which would improperly reflect the business done or the net income earned from the business done in this State.

The Commissioner argues, on the other hand, that his action is authorized by the first paragraph of the Section and that under that paragraph it is unnecessary that there be a determination that any such arrangement exists. His position is summarized in his memorandum as follows:

> "It is clear from this paragraph (first paragraph) that the Commissioner may treat a unitary group as one corporation where the group is controlled by the same interest, if (1) there is tax evasion or (2) the Commissioner determines that such action is necessary to clearly reflect income from California sources. <u>There need be no other showing.</u>"

The Appellant regards the first paragraph as applicable only to corporations doing business in this State and argues that the Commissioner's position is unsound for the reason, among others, that it deprives the third paragraph of any meaning whatever, whereas the section should be construed so as to give some force and effect to all parts thereof. To this, the Commissioner replies that his position does not render the third paragraph meaningless and that the "only purpose for placing the third paragraph in Section 14 was to give the Commissioner the power to assess a tax against a unitary group, a corporation which is part of the group operating in this State, or against another closer part of the group which might not be operating in this State."

The action of the Commissioner in combining the income of a corporation doing business in this State with that of a parent corporation not doing business in the State must, in our opinion, be justified under the third rather than the first paragraph of Section 14. The third paragraph is the far more specific of the two in its application to Appellant and its affiliated corporations, since it expressly provides that "...in the case of a corporation liable to report under this act and owned or controlled, either directly or indirectly, by another corporation, the Commissioner may require a consolidated report showing the combined net income or such other facts as he deems necessary." A determination that the first paragraph authorizes the Commissioner's action would, we believe, deprive the third of virtually all force and effect and would not, accordingly, be in accord with the legislative intent involved in the adoption of that paragraph.

We do not believe that the third paragraph is construed correctly as possessing only the very restricted meaning given it by the Commissioner. That paragraph does not purport to levy a tax on any corporation and, since Section 4(3) of the Act imposes a tax measured by net income only on corporations "doing business within the limits of this State," we are unable to understand wherein the paragraph authorizes such an assessment of tax against any other corporation. We conclude, accordingly, that the action of the Commissioner in allocating to California a portion of the combined net income of the three corporations must be justified under the third rather than the first paragraph of Section 14 as amended in 1937.

Section 14 as amended in 1935 contains only two paragraphs. The first is somewhat similar to the first paragraph of the 1937 amendments, In this case, it is the second paragraph upon which the action of the Commissioner must, in our opinion, be based. That paragraph reads, in part, as follows:

> "In the case of a corporation doing business within the meaning of this act ... owned and/or controlled either directly or indirectly by another corporation or corporations renders services of any nature whatsoever, or acquires or disposes of the products of the corporations so owning and/or controlling such corporation, in such a manner as to create a loss or improper net income, the commissioner, in order to prevent evasion of taxes or clearly to reflect the income of such a corporation, may require a report consolidated with the owning and/or controlling corporation or corporations, or such other facts as he deems necessary, and may determine the amount which shall be deemed to be the entire net income allocable to this State of the business of such corporation for the calendar or fiscal year, and compute the tax on such net income. In determining the entire net income

"the commissioner shall have regard to the fair profits which, but for any agreement, arrangement or understanding, might be or could have been obtained from dealing in such products, goods or commodities." (Underscoring added)

It is this paragraph which, by reason of its more specific language than that of the first paragraph, furnishes the possible basis for the action of the Commissioner. The portion of the Paragraph above underscored was omitted by the 1937 amendment which at the same time added the third paragraph of the Section. Here, too, the position of the Commissioner would deprive that portion of virtually all force and effect and is not, accordingly, in accord with legislative intent as expressed by the entire Section.

As heretofore mentioned, the Commissioner has not controverted in any way the allegations of the Appellant that all merchandise sold by P. Lorillard Company of New Jersey to Appellant was sold at the same prices as were available to other purchasers, less additional discounts, that those prices were fair, and that no arrangement existed between any of the corporations which would improperly reflec the business done or the net income earned from the business done in this State. The Commissioner's position has been based merely on his construction of Section 14, a construction which we have determined to be improper. In view of the uncontroverted allegations of the Appellant and the fact that the Commissioner has in no way asserted the existence of any arrangement of any sort between the Appellant and its affiliates which tended improperly to reflect the income from Appellant's business in this State, we would not be justified in presuming in support of the Commissioner's action that he had based that action upon a determination that such an arrangement existed,

Since we have held that the Commissioner's action in allocating to California a portion of the combined net income of Appellant and its two affiliated corporations was not authorized in the instant case, it is unnecessary for us to pass upon certain other issues presented by the appeal.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the action of Chas. J. McColgan, Franchise Tax Commissioner, upon the protests of P. Lorillard Company to proposed assessments of additional taxes, the taxes being redetermined in the amounts of $3,037.61, $2,704.41 and $3,967.54 for the taxable years ended December 31, of 1937, 1938 and 1939, respectively, pursuant to Chapter 13, Statutes of 1929, as amended, be. and the same is hereby reversed. Said ruling is hereby set aside and the said Commissioner is hereby directed to proceed in conformity with this order.

Appeal of P. Lorillard Company

Done at Sacramento, California, this 9th day of March, 1944, by the State Board of Equalization.

R. E. Collins, Chairman
J. H. Quinn, Member
Wm. G. Bonelli, Member
Geo. R. Reilly, Member

ATTEST: Dixwell L, Pierce, Secretary